

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

77-5034

United States Court of Appeals
For the Second Circuit

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In re APPLIED LOGIC CORPORATION,
Bankrupt

NEW JERSEY NATIONAL BANK,
Plaintiff-Appellant,
-against-

DANIEL GUTTERMAN, as Trustee of
APPLIED LOGIC CORPORATION, Bankrupt
Defendant-Appellee.

On Appeal from the United States District
Court for the Southern District of New York

BRIEF FOR DEFENDANT-APPELLEE

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On Appeal from the United States
District Court for the
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BRIEF FOR DEFENDANT-APPELLEE

Introductory Statement

This appeal arises out of written agreements made between Applied Logic Corporation ("ALC") and its major creditors prior to ALC's invoking the Bankruptcy Act in the Southern District of New York. ALC and its major creditors signed two "informal creditors' compositions" in an attempt to extricate ALC from severe financial difficulties.

Pursuant to these two agreements dated September 2, 1970 and September 15, 1971, ALC was required to do all its banking through an account at plaintiff-appellant New Jersey National Bank (the "Bank"); ALC's board of directors was replaced by a slate headed by the Bank's executive vice-president, who monitored ALC's account and operations on behalf of the leading creditors; ALC's debt was partially cancelled and partially extended; and ALC was required to raise working capital to be held at the Bank in certificates of deposit invested by the Bank "in the best interest" of all creditor parties to the two agreements.

This appeal concerns whether attempted set-offs in late 1974, 1975 and 1976 of funds held in ALC's account at the Bank should be disallowed. Bankruptcy Judge Babitt held that the "set-offs" could not be properly interposed in the factual situation at bar. District Court Judge Goettel affirmed.

Counterstatement of Issues Presented

1. Were the courts below correct in finding that the Bank was precluded from exercising "set-offs" of funds held in ALC's account at the Bank?

2. Where an insolvent corporation (a) is required to conduct all its banking activities at a creditor bank, (b) had its board of directors replaced by a slate imposed by its creditors, including that creditor bank, (c) has its account monitored by that bank for the benefit of leading creditors, and (d) is refused the right to withdraw large sums on deposit from the bank except with the bank's approval, is there mutuality of debts and credits within the meaning of Bankruptcy Act § 68a entitling the bank to set-off funds deposited in the corporation's account at the bank against antecedent debts owed by the corporation to the bank?

3. Was the factual finding made by the bankruptcy judge and affirmed by the district court, that the Bank had actually and impliedly assured other creditors that the Bank would not exercise any set-off, clearly erroneous?

4. If a bank has a lien on a bankrupt's assets, and those assets are duly sold on notice by the trustee in bankruptcy, is the bank entitled to the proceeds or to the full amount of its unpaid lien?

Prior Proceedings

ALC filed a voluntary petition for an arrangement pursuant to Chapter XI, section 322 of the Bankruptcy Act in the Southern District of New York on March 27, 1975. The case was referred to Bankruptcy Judge Asa S. Herzog.

Thereafter, on April 19, 1975, the Bank filed its complaint in that court. The Bank sought a determination of the validity of a security interest in all ALC's unencumbered assets, which the Bank requested be turned over to it. ALC, as debtor-in-possession, served and filed its answer and counterclaims, which, by leave of the court, was later amended on June 10, 1976. ALC conceded the validity of the Bank's security interest, but alleged that nothing was due to the Bank because of purported set-offs made by the Bank. ALC also alleged in its amended counterclaims that the purported set-offs made by the Bank were improper and that the funds so "set-off" should be returned to ALC. The Bank answered the amended counterclaims, denying any impropriety in making the set-offs and thereafter moved to dismiss the amended counterclaims.

On June 16 and July 24, 1975, a hearing took place before Judge Herzog. Following Judge Herzog's retirement, Judge David N. Edelstein assigned the bankruptcy

proceedings to Bankruptcy Judge Roy Babitt. A non-jury trial was held before Judge Babitt on June 23, 1976. At that hearing, the parties stipulated that the transcript of the proceedings before Judge Herzog and the exhibits then produced should be included as part of the record.

On August 10, 1976, prior to issuing his opinion in the action, Judge Babitt signed an order adjudicating ALC bankrupt and appointing defendant-appellee Daniel Gutterman as trustee in bankruptcy. Thereafter, pursuant to authorization by the bankruptcy judge, and upon notice to all creditors, including the Bank, the defendant-appellee sold all ALC's unencumbered assets, realizing the sum of \$40,000.

In his memorandum decision dated December 9, 1976, Judge Babitt found that the purported set-offs by the Bank were improper and by an order dated March 1, 1977, granted judgment to the trustee on all counterclaims in the amount of \$235,337.54. The Bank was granted judgment for \$40,000, being the cash proceeds from the sale of ALC's unencumbered assets, and was authorized to file a statement of claim for the balance of its claim as set forth in the complaint.

On March 31, 1977, the Bank filed its notice of appeal to the United States District Court for the Southern District of New York. In an opinion dated October 14, 1977,

Judge Babitt's decision was affirmed in all respects by District Judge Gerald L. Goettel.

The Bank filed its notice of appeal to this Court on November 14, 1977.

Counterstatement of Facts

1. ALC's Business and Financial Difficulties

ALC was in the computer "time-sharing" business. It owned computers and leased time for their use to its customers. Customers were then billed for the amount of time that the computers were used.

ALC was not a financial success. It borrowed heavily from various banks and fell behind in the payment of rent for equipment that it had leased. Accordingly, by the beginning of 1970, it was insolvent and unable to pay its debts as they became due (A-86, 97). Almost all of ALC's debt was owed to four banks and approximately seven equipment lessors. ALC began negotiations with its major creditors in an effort to avoid the closing down of the business (*A-199, 288). Its major creditors, including The Chase Manhattan Bank, N.A., First National City Bank, First National Bank of Princeton and plaintiff-appellant Bank, as well as six of

*References to pages in the Joint Appendix are made by the letter "A" followed by the page number of the Appendix.

the leasing companies (A-199, 404), entered into the negotiations which culminated in an agreement between ALC and its creditors dated September 2, 1970 (A-404 et seq.).

2. The Agreement of September 2, 1970 (the "1970 Agreement")

The purpose of the 1970 Agreement (A-404 through 436) was to grant a moratorium on both rental payments and demand notes. The recital to the agreement acknowledged that the arrangements being entered into were for the benefit of all parties concerned:

"Whereas ALC is indebted to the Banks, the Lessors and DEC [a computer manufacturer] in varying and substantial amounts and the parties hereto desire to reschedule the terms of payment of such sums in a manner mutually agreed upon to be in the best interests of all parties concerned." (A-404, 405)

The 1970 Agreement envisioned close control over ALC's financial affairs. Thus, ALC was required to conduct all banking of its funds through the Bank (A-409). A creditors' committee was established (A-422), among the members of which was a representative from the Bank, and this committee was to be given access to the books and records of ALC (A-423). ALC's chief executive officer was to make himself available to the committee to discuss any aspect of the business and operation of ALC (A-423).

Apart from being the depository of all ALC's funds, the Bank also coordinated the interests of the other

bank creditors of ALC. As set forth in paragraph 2 of the 1970 Agreement (A-408), the "banks" agreed to forbear demand for payment of the \$1,300,000 due to them on notes from ALC. This \$1,300,000 was converted into two notes, the first for \$300,000 to be held by the Bank "on behalf of First National Bank of Princeton," and the second, for \$1,000,000, to be held by the Bank "on behalf of the other Banks" (A-408).

By paragraph 4 of the 1970 Agreement (A-412) the Bank extended an irrevocable line of credit in favor of ALC for an additional \$100,000, but the other bank parties to the agreement agreed to (and did) participate in the line of credit in proportion to their interests in the \$1,000,000 note (A-412).

ALC was required to raise \$300,000 through the sale of convertible notes within twelve days of the execution of the 1970 Agreement (A-419).

Furthermore, it was to attain specified financial goals (A-418, 419) and to post security for its right to draw against the line of credit (A-413 through 417).

ALC was also required to furnish monthly to the creditors' committee a report showing cash receipts, cash expenditures and operating revenues (A-423, 424).

In May 1971, pursuant to the terms of the 1970 Agreement, ALC borrowed \$100,000 against the line of

credit. The \$100,000 was evidenced by a demand note (A-27 through 30) which provided that the \$100,000 was secured by:

"[A]ll unencumbered assets, including specifically: fixtures and equipment as listed in Schedule A attached, all inventory and after acquired inventory, all accounts receivable now or arising hereafter, all notes receivable"
(Emphasis added.) (A-27)

Contrary to the claim made by the Bank in its brief at page 13, the security interest did not extend to the money in ALC's account at the Bank. By its very terms, the demand note was made in accordance with the 1970 Agreement (A-27).

3. The Agreement of September 15, 1971 (the "1971 Agreement")

Under the terms of the 1970 Agreement, ALC was required to meet certain financial goals. However, ALC's financial difficulties continued. By September 1971, ALC's outstanding debts had risen to greater than \$10,000,000 (A-82).

A Recapitalization Agreement (A-61 through 82) was entered into on September 15, 1971 by essentially the same creditor parties who had executed the 1970 Agreement.

The 1971 Agreement provided for even stricter control over the affairs of ALC:

(a) ALC was required to raise \$500,000 in cash as working capital, \$300,000 of it within 60 days of the signing of the 1971 Agreement and the balance within six months thereof (A-65);

(b) Half of all outstanding loans and rental payments due to the creditors were forgiven (with the exception of the \$100,000 borrowed by ALC against the new line of credit provided under the terms of the 1970 Agreement) (A-66);

(c) A "special account" (A-69) was to be maintained at the Bank into which ALC was required to make payment of one-half of its positive cash flow each month toward the unforgiven portion of the debts due to the creditor parties to the 1971 Agreement. It was envisioned that the creditors would be paid by ALC from this special account within ten days after deposit (A-69, 70, 71);

(d) ALC was required to report monthly to the bank parties to the 1971 Agreement a current aging of its accounts receivable (A-70), and to attain specified financial goals (A-76);

(e) ALC was compelled to permit five of the seven seats on its board of directors to be filled by the creditors (A-74, 75), one of which was the Bank's executive vice-president Michael Lynch.

The 1971 Agreement merely amended the 1970 Agreement which, except where expressly changed, was to remain in full force and effect (A-78).

4. The Implementation of the 1970 and 1971 Agreements

It is obvious that the creditors felt that, by requiring ALC to do all its banking through one bank and to provide detailed financial statements, they would be able to oversee the affairs of ALC. By requiring all funds to pass through the Bank, itself a major creditor, the possibility of funds being diverted elsewhere was eliminated. The creditors were especially reassured to know that the Bank was holding \$500,000 of ALC cash for their mutual benefit.

In two respects the provisions of the agreements relating to banking were modified because of practical necessity:

- (1) Because ALC operated partially out of Princeton and because New Jersey law requires that employees have the right to cash their pay checks at a local bank, a "payroll" account had to be maintained in Princeton (A-236). The payroll account was funded from the account at the Bank (A-237).
- (2) The "special" account, referred to in the 1971 Agreement, was not set up (A-293, 294).

After discussions between ALC and the Bank, it was decided that, because all deposits and payments were required to go through the Bank anyway, it was not necessary to set up any separate accounts (A-294).

ALC had first opened an account with the Bank in 1968 (A-343). Prior to the 1970 Agreement, that account was used primarily for financing of equipment (A-235). Thereafter, all receipts and payments were required to pass through the account. The necessity of having checks initialed by the Bank was discussed (A-324). It was decided that this was not necessary, because to do so would give the impression to customers that the company was in financial difficulties (A-324).

The account was a "close-out debt account," monitored by the Bank on behalf of all the creditors (A-144). When a particularly large check was drawn, the Bank's approval was required (A-159). On several occasions checks were questioned (A-159, 160, 356). Pursuant to the requirements of the 1971 Agreement, ALC forwarded monthly agings of accounts receivable and payable to the Bank (A-245). Detailed financial reports were supplied by ALC at each board meeting (A-256). The Bank's representative on the Board attended most meetings (A-112, 113).

Payments that were required to be made to creditors under the terms of the 1971 Agreement were made from the account at the Bank (A-146, 147, 240). In addition, the creditors so paid were given a statement as to the computation of the amount paid (A-240).

5. Purchases of Certificates of Deposit

In exchange for the partial forgiveness and deferment of debt, the 1971 Agreement required ALC to deposit \$500,000 of new working capital to be held by the Bank (A-65). This amount was eventually raised and deposited (A-149). In order to maximize its income and accordingly improve its ability to meet its obligations to its creditors, ALC, after discussing the matter with the Bank, agreed that all these working capital funds should be invested in the Bank's own certificates of deposit ("CDs") (A-128, 149, 190, 242).

These CDs were "rolled-over" from time to time at the Bank, but the Bank refused to allow CDs to be purchased at other banks, even though interest rates were occasionally higher (A-151). And in June, 1974, the Bank refused to grant ALC's request to withdraw \$100,000 of the funds to meet impending payrolls (A-152), although the \$500,000 had been reduced by agreement of all parties to its 1970 and 1971 Agreements to meet the needs for working capital (A-262, 263).

Part of the funds on deposit were also set aside to meet a possible liability to the State of New Jersey in respect of sales taxes. In 1973, the State of New Jersey claimed \$60,000 from ALC in respect of unpaid sales taxes. ALC disputed the claim, but in doing so was required to post a bond against that state's levy (A-153). ALC discussed with the Bank how the matter should be handled (A-153). It was agreed that a letter of credit should be issued to support the required bond of New Jersey's lien (A-153). As security for the issuance of the letter of credit for \$60,000, it was agreed that it should be "covered" by setting aside funds from the money deposited by ALC in the account pursuant to the 1971 Agreement (A-264). In order to maintain high interest rates, a CD in the amount of \$100,000 was set aside to cover the letter of credit (A-153, 264).

6. Acceleration of Indebtedness and Set-offs

By letter dated July 3, 1974, the Bank notified ALC that it considered ALC in breach of the terms of the 1971 Agreement (A-158). Thereafter, the Bank exercised alleged set-offs against CDs that it was holding as follows:

- (a) December 3, 1974, \$100,739.58 (A-91).
- (b) December 9, 1974, \$101,551.11 (A-91).
- (c) December 31, 1974, \$41,485.42 (A-91). This amount was set off from the \$100,000 CD being held to cover the letter of credit (A-153).
- (d) April 16, 1975, \$830.62 (A-92).

(e). April 17, 1975, \$1,682.98 (A-93).

(f) April 1, 1976, \$26,095.76 (A-350). This amount was the balance remaining from the \$60,000 held by the Bank as security for the letter of credit for liability for New Jersey sales tax, after the liability for that sales tax had been determined and paid (A-350).

Within four months of the first "set-off," ALC filed a voluntary petition in bankruptcy pursuant to Chapter XI, Section 322 of the Bankruptcy Act.

The Complaint

The Bank's complaint (A-20 through 82) in the instant adversary proceeding referred only to the borrowing by ALC from the Bank in May, 1971 of the \$100,000 pursuant to the line of credit opened under the terms of the 1970 Agreement (not referred to in the complaint). The complaint also referred to the security agreement entered into between ALC and the Bank for the purpose of securing the loan (A-27 through 30) and claimed a balance due thereunder of \$56,862.93 (A-23). In its prayer for relief, the Bank requested a determination of the validity of the security interest in ALC's unencumbered assets, that the amount of its lien be fixed at \$56,862.93, and that ALC surrender possession of the secured assets to the Bank (A-23, 24, 25).

The Amended Answer and Counterclaims

In its amended answer and counterclaims (A-83 through 93), ALC admitted borrowing from the Bank and the existence of the security interest, but denied liability for the amount claimed by the Bank. ALC's counterclaims (A-84 through 90) demanded return of all amounts on deposit in this non-general account at the Bank.

In ALC's first counterclaim, which was brought pursuant to Bankruptcy Rules 701(1), 707 and 713 and "to recover a preference under Bankruptcy Act § 60 and § 67" (A-84), ALC made specific reference to the 1970 and the 1971 Agreements. In paragraph 9 of the amended answer and counterclaims (A-85) the following allegation was made:

"[P]laintiff held funds deposited by defendant in accordance with the 1970 Agreement in special accounts for the benefit of defendant and defendant's creditors." (Emphasis added.)

Further, in referring to the requirement that ALC raise additional capital pursuant to the 1971 Agreement, the amended answer and counterclaims alleged that:

"11. Defendant deposited said funds with plaintiff in the form of certificates of deposit drawn on plaintiff. With the consent of the signatories to said Agreements, said certificates of deposit were duly held in such trust capacity and were periodically renewed.

"12. Said certificates of deposit were not held by plaintiff in the ordinary course

of business, but were held for special purposes by plaintiff pursuant to the terms and conditions of the aforesaid Agreements." (Emphasis added.) (A-85)

The Bank's Answer to the Amended Counterclaims

In its answer to the amended counterclaims (A-94 through 105) the Bank asserted that it had retained a right to set-off the funds in ALC's account, that its set-offs were proper and that they were authorized by Bankruptcy Act § 68a (A-104). The Bank denied that it held the funds in the account on behalf of the other creditors (A-95), denied that the CDs were held in a trust capacity (A-96) and further denied that they were held for special purposes (A-96).

The Bankruptcy Judge's Opinion

In his opinion of December 9, 1976 (A-463 through 478), Bankruptcy Judge Babitt held that:

- (a) even if the "set-offs" were proper, any proceeds from the "set-offs" must first be applied to the secured loan upon which the Bank was seeking to foreclose (A-469, 470). By the time foreclosure was granted,

the "unencumbered assets," to which the Bank's security interest attached (A-27), were sold on notice for \$40,000 (A-478);

- (b) however, the set-offs were improper because the Bank could not deny that the funds held in ALC's account at the Bank were in the nature of trust funds deposited other than for general purposes (A-476); therefore, the unique nature of the account did not render the ALC funds a mutual debt which the Bank could apply to a general loan due to it from ALC.

Judge Babitt held that the Bank was entitled to judgment in the sum of \$40,000 and that the trustee was entitled to judgment in the amount of the improper "set-offs," for the benefit of all ALC's creditors (A-478).

The Affirmance by the District Court

The District Court affirmed the Bankruptcy Judge's opinion in all respects (A-492 through 507), recognizing that the uncontradicted evidence given at the trial established that the Bank had been primarily responsible for orchestrating the arrangements leading to the 1970 and 1971 Agreements and had closely monitored the financial affairs of ALC

(A-498). The District Court found no merit in the Bank's arguments that it had been denied procedural due process (A-500) and that the order of March 1, 1977 did not conform to the bankruptcy judge's opinion (A-505 through 507).

The District Court also disagreed with the Bank's "major challenge" to the holding below that the findings of fact were inadequate or clearly erroneous. Judge Goettel held that Judge Babitt's findings were supported by the record (A-501 through 504).

Summary of the Trustee's
Argument that the Decisions
Below be Affirmed

1. The courts below correctly found that the Bank could not exercise a set-off against ALC's account at the Bank. On the basis of equitable principles and the evidence introduced at trial -- which showed that the account was funded and operated pursuant to two agreements between an insolvent corporation and its creditors, that the corporation's board was controlled by its creditors and that the corporation was not free to make withdrawals at will -- the courts below correctly held that ALC's account at the Bank was not a "general account" against which the Bank could exercise a set-off under Bankruptcy Act § 68.

2. The Bank's security interest under the May 25, 1971 demand note did not extend to ALC's account at the Bank. The note did not mention the account in its long list of "unencumbered assets" pledged as security. Bank accounts are not subject to security interests. Under the 1970 and 1971 agreements, all deposits thereunder were impressed with the same equitable trust against which the Bank could not interpose a set-off.

3. The Bank was not denied procedural due process. ALC pleaded all the elements of a bankruptcy estoppel in its counterclaims by asserting that the Bank had no right to make the challenged set-offs. ALC was not required to plead an "affirmative defense" to allegations raised in the Bank's reply to ALC's counterclaims. The Bank was on ample notice to defend the propriety of its actions in making the set-offs.

4. The order dated March 1, 1977 conforms to the bankruptcy judge's opinion. The trustee has standing to sue under both Bankruptcy Act §§ 70a and 70e to set aside the Bank's alledged set-offs. The bankruptcy court did not attempt to vary any agreement between ALC and the Bank, pursuant to which one CD was pledged as security for New Jersey sales taxes. To the extent that the certificate was not used to satisfy the tax claim, the deposits it represented were subject to the same equitable trust which invalidated all the set-offs by the Bank against this factually unique account. The assignment was a security device which did not assign the underlying equity in the security.

ARGUMENT

POINT I. ON THE BASIS OF ALC'S COUNTER-CLAIMS AND THE EVIDENCE INTRODUCED AT TRIAL, THE COURTS BELOW CORRECTLY FOUND THAT THE BANK WAS PRECLUDED FROM EXERCISING SET-OFFS AGAINST FUNDS DEPOSITED IN ALC'S ACCOUNT AT THE BANK (Answering Points I and II in the Bank's Brief).

As the District Court pointed out in its decision affirming the opinion of the Bankruptcy Court (A-497), the primary issue in this action concerns the character of the funds held by the Bank in the account for ALC. The determination of the character of the funds was the lynch-pin to the holding that the Bank was not entitled to exercise a set-off permitted under Bankruptcy Act § 68a, 11 U.S.C. § 108 (1970).

- (a) The Bank could not interpose a set-off against the funds in ALC's account because there was no "mutuality of debts and credits" permitting a set-off under Bankruptcy Act § 68.

Although the Bank in its brief poses several theories in support of its claim that the courts below were in error, the Bank ignores the crucial factual findings of the bankruptcy court. These findings were affirmed by the District Court. What the courts below correctly decided was that, by the Bank's conduct in orchestrating the

arrangements leading to the signing of the 1970 and 1971 Agreements, its representation to the other creditors that it would not be in a position to exercise a set-off, its intimate relationship in the management of ALC's financial affairs and its holding large sums of ALC cash which could not be withdrawn, the Bank could not interpose a set-off because the funds in ALC's account had acquired the nature of a trust or special fund operated for non-general purposes.

The Bank pleaded that its alleged set-offs were authorized by Bankruptcy Act § 68. That section provides:

"a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subdivision g of section 57 of this Act; or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy."

With regard to a bank's rights under this provision to set-off funds deposited by a bankrupt more than four months prior to the depositor's bankruptcy, it is the accepted rule that, under the principle of "mutuality," a bank may set off

the funds in the account against a debt due to the bank provided the deposit is of a general character. New York County National Bank v. Massey, 192 U.S. 138 (1904). However, where the deposit is for non-general purposes, there is no mutuality and the bank may not "set-off" the funds in the account. See 4A Collier on Bankruptcy, ¶ 68.16 (14th Edn. 1975):

"[W]here the deposit is not one of a general character but, rather, a deposit for a special purpose..., the money is held as a trust fund and not as bank assets and thus the bank is without right to appropriate the deposit to its own use as a set-off."

Accord, Goggin v. Bank of America National Trust & Savings Association, 183 F.2d 322 (9th Cir. 1950), cert. denied 340 U.S. 877 (1950); First National Bank of Clinton v. Julian, 383 F.2d 329 (8th Cir. 1967).

(b) There can be no "mutuality" where deposits are made other than for general purposes

In their interpretation of the provisions of Bankruptcy Act § 68a, courts have held that there can be no "mutuality" where the deposits made are other than in the normal course of business and the deposits are not withdrawable at the will of the depositor. That is, in those circumstances the deposits cease to be general.

Thus, in Kaufman v. First National Bank of Opp, Ala.,
493 F.2d 1070, 1072 (5th Cir. 1974), the court held:

"[F]unds deposited for a special purpose known to the bank, or under special agreement, cannot be set off by the bank. 5A Michie, Banks & Banking, § 129, p. 352. A deposit is special rather than general when there is specific direction or agreement express or implied, that it be special or where there are circumstances sufficient to create a trust by operation of law. 5B Michie, Banks & Banking, § 328, pp.26. The consequence of a deposit's being special in the sense that it cannot be subject to setoff is at times described in trust terms." (Emphasis added.).

This Court has twice reiterated the requirement that before a valid set-off may be made the funds must have been deposited in the normal course of business and be withdrawable at the will of the depositor. In Miller v. Wells Fargo Bank International Corp., 540 F.2d 548, 557 (2d Cir. 1976), this Court held that while a valid set-off by a bank could not be recovered as a preference under Bankruptcy Act § 60a, it was an exception permitted only in the proper circumstances.

"In the case of bank accounts this exception applies only to deposits made in good faith, in the due course of business, which are subject to withdrawal at the will of the depositor" (Emphasis added.)

So too, in Katz v. The First National Bank of Glen Head, Docket No. 76-7577, ___ F.2d ___ (2d Cir. 1977), CCH

Bankruptcy Rep. § 66,566 at 76,502, this Court again held that a valid set-off is only permissible if the funds are withdrawable at will and are deposited in the normal course of business:

"All the courts that have relied upon a debtor-creditor relationship between a bank and a depositor to preclude a finding of a transfer have emphasized not only the requirement that the funds be withdrawable at the will of the depositor but also the requirement that the deposits be made in the regular course of business."
(Emphasis added.)

Although the Bank in Point II of its brief asserts that the decisions of the lower courts are in conflict with this Court's decision in Katz, the factual and procedural differences between Katz and the instant case are marked. Moreover, contrary to the Bank's claim, this Court's decision in Katz supports the decisions of the courts below that deposits not made in the ordinary course of business and not withdrawable at the will of the depositor cease to be "general deposits" against which the bank may exercise a set-off under Bankruptcy Act § 68a.

Thus, in Katz the question before the Court was the relationship between a bank and its depositor and whether deposits into the account, which had been built up over a period of time, were made in good faith and in the ordinary course of business. This Court reversed the District Court's decision granting summary judgment in

favor of the bank there, because it found that there were factual questions that were to be determined by a jury. In reaching its decision, however, this Court pointed out that in order for a set-off to be valid, the funds must have been deposited in the ordinary course of business and have been withdrawable at the depositor's will.

The instant appeal is from a full trial. Factual findings were set out in a fifteen page opinion by the learned trial judge. These factual findings were carefully reviewed by Judge Goettel who affirmed in all respects the facts which formed the basis of the conclusions made below by Bankruptcy Judge Babitt.

Bankruptcy Judge Babitt found that the deposits at issue were made by an admittedly insolvent corporation pursuant to written compositions with creditors. The creditors required ALC to raise huge amounts of "working capital" in order to attempt rehabilitation. These funds were required to be kept in certificates of deposit at the

Bank. More than \$235,000 was so kept for a period of years. ALC obviously tried to use these funds to avoid filing under Chapter XI. ALC tried to use these funds to avoid liquidation. Holding such a large sum during years of insolvency is not "ordinary," as the Bank now asserts in its Brief.

In Katz, there were no 1970 and 1971 Agreements as here, no history of conceded insolvency as here, no senior vice-president of the Bank and creditors controlling the board, no "close-out debt" account, and none of the facts found by the courts below in the instant case.

- (c) Deposits made other than for general purposes take on the nature of a "trust fund" or "special deposit" not subject to set-off.

Where a deposit is made by a depositor into a bank account for non-general purposes, the bank's normal right of set-off against those funds is precluded:

"A bank's right of set-off against a deposit does not exist where the deposit is made for a special and particular purpose. A bank impliedly binds itself, by accepting a special deposit, not to set off against such deposit a debt due from the depositor, and a bank which accepts a deposit of money for a special purpose, under an agreement that it will pay the amount, when needed, for that purpose, cannot legally appropriate such deposit to discharge the depositor's indebtedness to it." 10 Am. Jur.2d, Banks, § 673.

Such deposits are regarded as being held "in trust" by the bank [Killoren v. The First National Bank in St. Louis, 127 F.2d 537 (8th Cir. 1942)], which as "trustee has no right of set-off against the fund for amounts due and owing to the trustee by the depositor." United States v. Butterworth-Judson Corp., 267 U.S. 387 (1925); Libby v. Hopkins, 104 U.S. 303 (1881); Menkes Feuer, Inc. v. Peoples Bank of Johnstown, 43 N.Y.S.2d 32 (Sup. Ct. Fulton Co., 1943); Cassedy v. Johnstown Bank, 246 App.Div. 337 (3d Dept. 1936); Bank of Commerce & Trusts v. Hatcher, 50 F.2d 719 (4th Cir. 1931); Goggin v. Bank of America National Trust & Savings Ass'n, supra.

The term "trust" is not construed narrowly to include only formal trusts but is liberally construed to denote all funds held for special or "non-general" purposes. Whether those "special purposes" exist can be determined only after an analysis of all the facts and circumstances. Killoren v. The First National Bank in St. Louis, supra. There the court decided that a bank deposit was held in "trust" when the deposits made "were for a special purpose, or . . . they were funds in which third parties had an interest, so as to impress them with a trust" (Emphasis added). Id. p. 542. Cf. Noah's Ark Auto Accessories, Inc. v. First National Bank of Rochester, 64 Misc.2d 944 (Sup.

Ct. Monroe Co. 1970), aff'd 37 App.Div.2d 692 (4th Dept. 1971); Bank of West Orange v. Associates Discount Corporation, 197 So.2d 858 (Fla. 4th Dist. 1967); Mid-City National Bank of Chicago v. Mar Building Corporation, 33 Ill. App. 3rd 1083, 339 N.E.2d 497 (1975).

- (d) The Bankruptcy Court found that deposits made into ALC's account at the Bank were not in the ordinary course of business

In reaching its decision, the bankruptcy court held that, on the basis of the evidence introduced at trial, funds deposited in ALC's account at the Bank were not deposited in the "ordinary" course of business and were not withdrawable by ALC at will. Accordingly, there could be no "mutuality of debts and credits" giving the Bank authority to set-off in accordance with the provisions of Bankruptcy Act § 68a. First National Bank of Portland v. Dudley, 231 F.2d 396 (9th Cir. 1956). See also Katz v. The First National Bank of Glen Head, supra.

Thus, the court below agreed with the trustee that the Bank should be precluded from exercising its right of set-off, because:

"[N]ot only did the Bank play a key role in negotiating the 1970 and 1971 agreements, but it also monitored both the account and ALC's affairs.... The Bank also received detailed monthly reports of the Bank's current aging of ALC's accounts receivables.... Moreover, Lynch testified that in the discussions with the other bank creditors, immediately prior to the execu-

tion of the 1970 agreement, which concerned making the Bank the exclusive beneficiary of the banking activities of ALC, the other creditor banks were specifically concerned that the additional capital required to be raised under the agreement would be set off by the depository bank." (A-474, 475).

Furthermore, Judge Babitt found that it was significant that the Bank was to share rateably with all the other creditors in the funds generated, and that the Bank had impliedly waived its right of set-off by entering into the pro-rata arrangement contained in the 1970 and 1971 Agreements (A-476, 477). Moreover, he found that the Bank had represented to the other creditors that it would not be in a position to exercise a right of set-off, so that the Bank could not in equity and good conscience be permitted to keep its rateable share of distribution plus the right of set-off (A-477).

The Bank questions, in its brief at Point I, Judge Babitt's "interpretation" of the testimony given by the Bank's executive vice-president Lynch (A-371, 372), even though this was only one of many factors that led Judge Babitt to reach his decision that the Bank's "set-offs" were improper. The Bank alleges that Judge Babitt's findings as to that testimony were clearly erroneous. However, what Lynch's testimony indicates is that the Bank was fully aware that it was not dealing with an ordinary account, but was dealing with an account in which the other

creditor parties had an interest and were concerned about the Bank exercising a set-off.

The relevant testimony by Lynch was as follows (A-371, 372):

"Q. You were ready to clarify the subject of set-off. You were stopped. Is there anything you want to

A. I think there was a discussion. It is a little fuzzy. I think the concern evidenced by some of the other creditors was that the additional capital would be deposited in the Bank. The capital that was required under the agreement and the day after it was deposited it would be set off. I told them that if the agreement was put together and signed and we didn't have a past due note at that time, we had no way to set off. So whether we wanted to or not we couldn't."

In his opinion, Bankruptcy Judge Babitt referred to the testimony of Lynch when he held that the Bank:

"confronted with the apprehensions of the other creditor banks that the depository bank could assert a right of set off, represented that it would not be in a position to do so." (A-477)

And District Judge Goettel, in affirming the bankruptcy court, held that:

"There was testimony in the record to support the conclusion that Lynch, an officer of [the Bank] serving on ALC's board, reassured other creditors that set-offs would not be made." (A-504).

Lynch's testimony is clear and the bankruptcy judge was entitled to draw his conclusions from it. Even assuming that there was some force to the Bank's argument, Judge Babitt's findings are not "clearly erroneous" and should not be set aside. Bankruptcy Rule 752; Fed. R. Civ. P. 52; Williams v. Wirt, 441 F.2d 1150 (5th Cir. 1971); Coen v. Zick, 458 F.2d 326 (9th Cir. 1972); McCarty v. Small Business Administration, 420 F.2d 943 (5th Cir. 1970). Furthermore, Bankruptcy Rule 752 requires the reviewing court to give due regard:

"[T]o the opportunity of the trial court to judge the credibility of the witnesses."

See United States v. Yellow Cab Co., 338 U.S. 338, 341 (1949); Zenith Radio Corp. v. Hazeltine Research Inc., 395 U.S. 100 (1969).

Based upon all the factual findings which were fully supported by the record and because the dominant impulse in bankruptcy is to effect equality among creditors, the courts below held that the deposits were in the nature of trust funds for the benefit of all ALC's creditors and that accordingly the Bank had no right of mutual set-off.

- (e) The courts below based their decisions on equitable principles which required them to find that the Bank should not be in a superior position to other creditors.

In addition to the other factors requiring the courts below to hold that there was no mutuality of debts

and credits permitting the Bank to exercise a set-off under Bankruptcy Act § 68a, equitable considerations mandated that the courts find that the Bank should not be permitted to reap special benefits from its position as coordinator of the arrangements under the 1970 and 1971 Agreements.

Although in its brief in Point II the Bank attacks the decisions of the courts below and the Ninth Circuit's decision in First National Bank of Portland v. Dudley, supra, as being based upon "abstract non-specific 'equitable considerations'" which "will have a chilling effect on banks who might otherwise work closely with insolvent debtors" to effect settlements of their financial problems, the Bank ignores the unique factual situation of the case at bar and the fact that bankruptcy courts are courts of equity. As this Court held in Katz v. The First National Bank of Glen Head, supra:

"The bank insists here that a deposit will constitute a transfer under §60(a)(1), only if the trustee can prove the bank's complicity in, agreement to, or conscious awareness of, the build-up in the account in anticipation of a set-off. That is not the law. If it were, equity would be precluded from looking through form to substance-even in a case of as blatant a preferential transfer as that alleged by the trustee here." (Emphasis added)

- (i) The courts below were required to employ equitable principles in rendering their decisions

Bankruptcy Act, § 2a provides that:

"The courts of the United States ... are hereby created courts of bankruptcy and are hereby invested ... with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction under this act...."

It has been consistently held that a bankruptcy court is a court of equity which will look through the form to the substance of any particular transaction:

"[T]he court, in the exercise of equitable jurisdiction, may sift the circumstances surrounding any claim in order to insure that injustice or unfairness is not accomplished in the administration of the estate and in so doing it may adopt that remedy which it deems most appropriate under the circumstances [citations omitted]"

1 Collier on Bankruptcy, supra, ¶ 2.09, n. 5; Katz v. The First National Bank of Glen Head, supra. In Pepper v. Litton, 308 U.S. 295, 304, 310, 311 (1939), the Supreme Court stated that:

"[T]his Court has held that for many purposes 'courts of bankruptcy are essentially courts of equity.' Local Loan Co. v. Hunt, 292 U.S. 234, 240. By virtue of § 2 a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the Act, it applies the principles and rules of

equity jurisprudence. Larson v. First State Bank, 21 F.2d 936, 938....

"[A] sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant."

See also Bank of Marin v. England, 385 U.S. 99 (1966); Katchen v. Landy, 382 U.S. 323 (1966); Carrier Corp. v. J.E. Schecter Corp., 347 F.2d 153 (2d Cir. 1965).

In the exercise of equitable principles, the bankruptcy courts seek to achieve equity among the creditors and ensure that the administration of the bankrupt estate is conducted in an equitable manner. Thus, in Bank of Marin v. England, supra, the Supreme Court stated at 103:

"There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."

In Manufacturers Trust Co. v. Becker, 338 U.S. 304, 310 (1949), that court had earlier held:

"[T]he court must reject any claim that would not be fair and equitable to other creditors."

In In re Laskin, 316 F.2d 70, 72 (3d Cir. 1963), it was held that:

"One of the primary purposes of the Bankruptcy Act is the equitable distribution of the bankrupt's estate among its creditors."

See also In re Elkins-Dell Manufacturing Co., 253 F. Supp. 864, 868 (E.D. Pa. 1966), where it was held that:

"The bankruptcy court has the power 'to prevent the consummation of a course of conduct which . . . would be fraudulent or otherwise inequitable' Heiser v. Woodruff, 327 U.S. 72, 73"

- (ii) Applying principles of equity, the courts below held that the funds in the ALC account had the character of a trust fund precluding any right of set-off

In deciding against the Bank, the courts below held inter alia, that the funds in ALC's account had the character of a trust fund. As Judge Babitt found, all the circumstances surrounding the account and its operation indicated that the funds in the account were not "ordinary" funds but were deposited for the benefit of ALC's creditors. Thus, ALC was required to do all its banking at the Bank (A-236, 409), even though prior to the 1970 Agreement it had had accounts elsewhere (A-235, 236). This unique account was used for making to creditors the payments required under the 1971 Agreement (A-238, 240). The 1971 Agreement required ALC to open a special account at the Bank, but it was decided in discussions between the Bank and ALC that opening a second "special account" would be superfluous (A-241, 293, 294). This decision was later authorized by the Board of Directors (A-395). In order that the Bank could "monitor" the account (A-145, 245, 474), ALC was required to forward to the Bank

monthly statements of accounts payable and accounts receivable (A-245). The Bank had the right to and did question checks drawn on the account (A-244, 246, 254), although it was agreed that the necessity for initialling all checks would be dispensed with (A-324). The capital that ALC was required to raise under the terms of the 1971 Agreement had to be deposited in the account where it was used to purchase certificates of deposit (A-128, 149).

The evidence at trial showed that this was no ordinary account. The Bank scrutinized anything out of the ordinary. It would not allow ALC to purchase CDs at other banks, even though other banks were then paying a better rate of interest (A-150, 260). Checks to Webster-Todd (a mortgagee) were questioned (A-159, 160, 356). ALC could only purchase CDs if the Bank permitted it (A-243). In June, 1974 the Bank refused to allow ALC to withdraw funds to meet its payroll (A-152).

Added to these extraordinary features were the facts that the Bank played an intimate role in the formulation and execution of plans for the payment of ALC's creditors, that the creditors of ALC formed a majority of its board (A-74, 75, 154) to whom ALC made monthly reports giving full details of its financial position (A-200, 256), that the account was being run pursuant to the terms of the 1970 and 1971 Agreements and that it was being "monitored

and supervised by the Bank" (A-158) for the benefit of all parties to the 1970 and 1971 Agreements (A-405).

Because the arrangements entered into between ALC and its creditors were for the benefit of all the parties, it is clear that the Bank, which was given actual control over the financial affairs of ALC, was in a special capacity vis-a-vis ALC and its creditors. The account through which ALC had to make all its transactions was "set up" pursuant to the 1970 and 1971 Agreements which were for the benefit of all parties, and accordingly the normal debtor-creditor relationship between a bank and its customer in this case did not exist.

In view of all these special circumstances, the courts below held that ALC's account at the Bank was not a general account and that the Bank was precluded from asserting that there were "mutuality of debts and credits." (A-475, 476). The holdings below were consistent with established bankruptcy doctrine that, when a creditor bank agrees with a debtor and other creditors for the use of funds deposited with the bank for the payment of creditors and participates in carrying out such a plan, funds deposited with the bank constitute an equitable "trust fund" for the benefit of creditors, which is not subject to set-off. United Bank & Trust Co. v. Loble, 20 F.2d 124, 126 (9th Cir. 1927), cert. denied 275 U.S. 545 (1927); First National Bank of Portland v. Dudley, supra.

In similar cases, where a bank not only advised a debtor to take certain action but, as in the instant case, has taken an active role in the management of the debtor, the principle of equitable estoppel will apply to prevent that bank from setting off funds accumulated in the debtor's account for the benefit of creditors. Twentieth Street Bank v. Gilmore, 71 F.2d 594 (4th Cir. 1934); First National Bank of Waco v. Sheehy, 29 F.2d 400 (5th Cir. 1928).

Under equitable principles, the admitted facts of the instant case and judicial precedent, the courts below found that the set-offs were improper and would have resulted in inequality among creditors contrary to the scheme of the Bankruptcy Act (A-478). The Bank was not a stranger to the arrangements that resulted in essentially all of ALC's funds being deposited for special purposes in its account at the Bank. Such deposits cannot be construed as an arms-length transaction. Furthermore, these were funds deposited as required by the 1971 Agreement. As such they comprised a substantial portion of the corpus held for creditors. Moreover, the 1970 Agreement and the circumstances surrounding its execution lead to the inescapable conclusion that the Bank clearly understood the purposes of the clause which required all of ALC's banking to be performed through the Bank. The Bank concedes that no language in either the 1970 or the 1971 Agreement authorizes or condones set-offs.

The courts below correctly concluded that, had the other creditor parties been aware that the "required banking" clause could place the Bank in a preferred position, they would have sought to have ALC's funds kept in a non-creditor bank.

Despite the Bank's pleas to this Court on "policy" grounds based upon so-called "new philosophies" of the Supreme Court as to rights of secured creditors (Bank's Brief, Point II, B), the established law and the factual situation of this case required the courts below to conclude that ALC's account at the Bank was not maintained in the ordinary course of business and that the Bank could not interpose set-offs against such an account.

POINT II. THE BANK ONLY HAD A SECURITY
INTEREST IN ALC'S UNENCUMBERED
ASSETS, WHICH DID NOT INCLUDE
ALC's ACCOUNT AT THE BANK
(Answering Point III in the
Bank's Brief).

In Point III of its brief, the Bank claims that the "unencumbered assets" against which its security interest for \$56,862.93 extended under the terms of the May 1971 demand note (A-27), included the money and CDs in ALC's account at the Bank. The Bank also alleges that the bankruptcy court erred in not setting forth findings of fact as to why the Bank's security interest did not extend to the money and CDs in ALC's account and why the Bank could not apply the proceeds of the CD assigned to cover the prospective liability for New Jersey sales taxes against the indebtedness due from ALC to the Bank.

The Bank again fails to cite any authority for its claim that its security interest would extend to the cash on deposit in ALC's account at the Bank. The Uniform Commercial Code provides that security interests do not extend to bank accounts. See N.J. Stat. Ann. § 12A:9-306 (West). The bank account is not mentioned in the three-page security schedule of "unencumbered assets" annexed to the \$100,000 note itself (A-28 through 30).

More significantly, Judge Babitt found that, on the basis of the circumstances under which the account

was funded, all deposits into ALC's account took on the equitable character of a trust fund against which the Bank could not interpose any set-off. Each CD was subject to the same equitable considerations and was immune from the Bank's right to set-off. The same considerations apply to the CD that was assigned to cover ALC's prospective liability for New Jersey sales taxes. The funds constituting that CD were impressed with the same "equitable trust" against which the Bank had no right of set-off. The funds were so "encumbered" from the time of their deposit.

The Bank made identical contentions in the District Court below. Judge Goettel found them to be without merit (A-506, 507):

"Next, plaintiff argues that the judgment in its favor should not have been limited to the proceeds of the inventory sale, claiming that its security interest would extend to the cash on deposit with NJNB. Plaintiff does not cite any authority for its novel claim that it had a perfected security interest in cash on deposit, as opposed to cash constituting proceeds from the sale of assets subject to its security interest. See N.J. Stat. Ann. § 12A:9-306 (West) (Uniform Commercial Code). It appears clear that, by limiting plaintiff to the proceeds of the inventory sale while permitting a general claim for any deficiency, Judge Babitt implicitly recognized the security interest as extending only to the identified assets.

Finally, plaintiff takes issue with the purported failure to recognize the validity of an assignment of another certificate of deposit. This was the certificate assigned as collateral for the issuance by NJNB of a letter of credit in favor of the state of New Jersey to guarantee defendant's payment of a disputed [sales] tax assessment. The clear import of the opinion is that, to the extent the certificate was not used to satisfy the tax claim, the deposits it represents are subject to the same equitable trust which invalidated the set-offs and, therefore, any assignment was void ab initio."

The Bank's further assertion that the bankruptcy court made no findings of fact regarding the CDs is, therefore, meaningless. A special finding of fact with respect to the Bank's interest in each particular CD was unnecessary. A clear finding was made as to the entire account.

As provided in Bankruptcy Rule 752:

"If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein."

The purpose of Bankruptcy Rule 752 is to ensure that the reviewing court is informed of the basis of the lower court's decision. If the court has a "clear understanding" of the bases of the lower court's decision so that effective review is possible, it is not necessary for the facts to be found specially. In re D. H. Overmyer, Co., Inc., 510 F.2d 329 (2d Cir. 1975); In re Bolton Hall Nursing Home, 432 F. Supp. 528 (D. Mass. 1977). The bankruptcy judge's opinion provides

the "clear understanding" necessary for review and special findings are not required.

At page 49 of its brief the Bank contends that, at trial, counsel for ALC conceded that the Bank would be entitled to retain \$100,000 in the event ALC prevailed on its counterclaims. Such a contention is a misreading of the transcript. What trial counsel for ALC said (A-276) was that, because ALC conceded that the Bank had a security interest in ALC's unencumbered assets, the value of those assets could be retained by the Bank out of the funds improperly set-off and only the balance returned to ALC. At the time, ALC was using its "unencumbered" equipment in ALC's operations. After ALC was adjudicated a bankrupt, these "unencumbered" assets were duly sold by the Trustee on notice to all creditors including the Bank. The sale grossed \$40,000, which is the precise amount which the courts below ordered to be turned over and credited to the Bank.

Of course, at trial, the Bank conceded that it had previously taken proceeds of the sale of some of ALC's unencumbered assets in repayment of the \$100,000 loan. Thus, when ALC sold equipment to Grumman for about \$35,000, Lynch informed ALC that:

"[T]his should go as a reduction against the one hundred thousand dollar loan the bank had given Applied Logic for which they had a lien on unencumbered assets." (A-255).

Accordingly, under no circumstances would the Bank have been entitled to recover \$100,000 on this loan in the instant action.

POINT III. THE BANK WAS NOT DENIED PROCEDURAL DUE PROCESS BECAUSE IT WAS ON NOTICE AS TO THE THEORY OF RECOVERY INTERPOSED IN THE COUNTERCLAIMS. (Answering Points IV and V in the Bank's Brief).

In its brief at Point IV, the Bank asserts that it was denied "procedural due process" because it received no notice that a cause of action based upon an estoppel would be pleaded against it and that the bankruptcy court found that it was "estopped" from asserting a right of set off.*

As Judge Goettel in the District Court found, such a claim has little force when viewed against the causes of action asserted in the counterclaims. As the counterclaims stated, the Bank should be required to return the funds allegedly "set-off" because the account had been governed and operated in accordance with the 1970 and 1971 Agreements for the benefit of ALC and its creditors and was not a general account. In effect, therefore, ALC pleaded that the Bank was unable to assert a right of set-off.

* A sophisticated commentator recently stated that the instant record fully supported a finding that the account was an expressly "special" account which would preclude a set-off. Leibowitz, Banks' Right To Setoff in Bankruptcy: "From Erosion to Extinction?", 94 THE BANKING LAW JOURNAL, No. 9, 796, 811 (1977)).

Bankruptcy Rule 708 provides that Fed. R. Civ. P. 8 applies to adversary proceedings in the Bankruptcy Court. The counterclaims interposed by ALC, therefore, were required to be pleaded in accordance with the rule which requires that a claim for relief must include the grounds for the court's jurisdiction, a short statement of the claim showing that the pleader is entitled to relief and a demand for judgment. Fed. R. Civ. P. 8(a). That rule also provides that "no technical forms of pleading or motions are required." Fed. R. Civ. P. 8(e)(1).

If the elements of an estoppel have been pleaded, the court will not refuse to consider a plea merely because the label "estoppel" has not been fixed to it. Thus, in Cohen v. Superior Oil Corporation, 16 F. Supp. 221 (D. Del. 1936), the court was willing to consider a plea to be estoppel even though it had not been sufficiently designated as such. At 31 C.J.S. Estoppel, § 153(3)(c), it is pointed out that:

"If the matter constituting an estoppel is apparent on the face of the pleadings it need not be specifically pleaded to be available...."

In Travelers Indemnity Co. v. Peacock Construction Co., 423 F.2d 1153 (5th Cir. 1970), the Court of Appeals affirmed the trial court's findings that estoppel had in effect been pleaded, rejecting appellant's argument that estoppel was not expressly pleaded.

Moreover, because ALC was the counterclaimant below, it did not have the pleading opportunity (as the Bank suggests) to assert "estoppel" as an "affirmative defense". In its counterclaims, ALC requested judgment requiring the Bank to return the funds that the Bank had "set off", because the funds in ALC's account at the Bank were in the nature of trust funds. In its reply to the amended counterclaims, the Bank alleged that the set-offs were authorized by Bankruptcy Act § 68a. At no time could ALC have specifically pleaded any affirmative defense to a reply to a counterclaim.

In any event, the Bank was on good and explicit notice as to all issues pleaded in the amended answer and counterclaims. ALC alleged that the Bank should be required to return the funds "set-off," because the Bank held funds in an account for ALC pursuant to the terms of the 1970 and 1971 Agreements and could not now claim that those funds were deposited in the ordinary course of business. Thus, ALC alleged that:

- The Bank entered into an agreement on September 2, 1970 pursuant to which the Bank was required to hold funds "on behalf of the other creditors of defendant" (amended answer and counterclaims, ¶ 8, A-84).

- The Bank held funds deposited by ALC in special accounts for the benefit of ALC and ALC's creditors (id. ¶ 9, A-85).
- Pursuant to a further agreement dated September 15, 1971, ALC was required to deposit further sums into the special account, which sums were invested in certificates of deposit and as such were held for the special purposes of the 1970 Agreement (id. ¶¶ 10-12, A-85).

The Bank was on sufficient notice to defend its improper set-offs from attack on every flank.

In support of its allegations that the decision of the court below should be reversed because no estoppel was shown, in Point V of its brief the Bank mistakenly describes the necessary elements of "equitable estoppel" by citing a large number of non-bankruptcy cases.

In bankruptcy, an estoppel may exist where a creditor seeks to take a position contrary to his earlier course of conduct, which course of conduct has been relied upon by others to their detriment. 3A Collier on Bankruptcy, supra, ¶ 63.07[4]; First National Bank of Bay City v. Young's Estate, 41 F.2d 8 (6th Cir. 1930); Eads Hide & Wool Co. v. Merrill, 252 F.2d 80 (10th Cir. 1958).

It was clear from the 1970 and 1971 Agreements that it was the understanding of all the parties that they would each benefit from the arrangements made. Working capital was to be raised and deposited in the account from which payments to the creditors were to be made. As Judge Babitt found, all the creditors were to share rateably in the amounts to be distributed from the account. That the arrangements entered into were to be for the benefit of all parties, none of which was in a superior position to the others, is reflected by the preamble to the 1970 Agreement which states (A-404, 405):

"Whereas ALC is indebted to the Banks, the Lessors and to DEC in varying and substantial amounts and the parties hereto desire to reschedule the terms of payment of such sums in a manner mutually agreed upon to be in the best interests of all parties concerned." (Emphasis added.)

The Bank was a party to and the orchestrating force behind the 1970 and 1971 Agreements. It monitored ALC's account, was represented on ALC's board, and was aware that the arrangements were for the mutual benefit of all creditor parties. The parties agreed that ALC's banking was to be done through the Bank. The creditors were entitled to rely upon the Bank's agreement that the arrangements were for the benefit of all of them. The Bank, as holder of the funds, was in a special position vis-a-vis the other creditors who relied upon its good faith in the operation of the

terms of the 1970 and 1971 Agreements. In addition the Bank was aware that it was not dealing with a general account and that the other creditors were concerned about the possibility of set-off in discussions prior to the execution of the 1970 Agreement. The Bank said it would not be in a position to exercise the set-off. Accordingly, on the basis of the foregoing undisputed facts, the other creditors of ALC were entitled to rely on the Bank's position as another creditor without superior rights.

Having relied on the Bank's conduct and the arrangements entered into for the benefit of all ALC's creditors, the creditors were prejudiced when the Bank set-off funds that would otherwise be available to the bankrupt estate for rateable distribution to all creditors. The Bank's allegations that it "clearly stated to certain creditors" that it retained its right of set-off (Bank's brief at p. 59) and that its "conduct was consistent with the retention . . . of the right of set off" (id. 59-60) are not supported by either the record or Judge Babitt's findings.

The Bank also alleges error on the part of the Bankruptcy Judge in implying that the Bank should be estopped from asserting a right of set-off "because it had remained silent" about its right of set-off (Bank's brief at p. 60). However, what Judge Babitt held was,

following the holding of First National Bank of Portland v. Dudley, supra, that in the circumstances of the case the Bank was required to have expressly retained a right of set-off because its conduct and the implications of the 1970 and 1971 Agreements pointed to the Bank having relinquished its right of set-off. The Bank concededly failed to make such a reservation in its 1970 Agreement, the 1971 Agreement or even in the note sued upon in the complaint.

Nor is there any merit in the Bank's contention in its brief at pp. 47-48 that all the "1970 Agreement Creditors" were at all times aware of the facts, consented to the 1970 Agreement, received the benefits of the 1970 Agreement "and are estopped from denying Bank its set-off rights against the Account." Such an assertion is contrary to Judge Babitt's findings and has no support on the record.

POINT IV. JUDGE BABITT'S ORDER OF
MARCH 1, 1977 CONFORMS TO
HIS OPINION OF DECEMBER
9, 1976 (Answering Point
VI in the Bank's Brief).

The Bank mounts a two-fold attack upon the Order of March 1, 1977 (A-479 through 483), asserting that:

- (i) the bankruptcy court impressed a constructive trust on the account in favor of all ALC's creditors, so that it is not the property of the bankrupt estate and therefore the trustee has no standing to support ALC's counter-claims; and
- (ii) the bankruptcy court has no authority to alter the terms of the contracts entered into between ALC and the Bank where ALC purportedly sanctioned the Bank's right of set-off.
 - (a) The trustee has standing to sue because the issue before this court is "mutuality of debts" and not the existence of a constructive trust.

In its defense to the amended counterclaims, the Bank asserted that its purported set-offs were authorized under the provisions of Bankruptcy Act § 68. Set-offs

under that section are only permitted if there is mutuality of debts and credits. Accordingly, the issue before the court was whether there was "mutuality" within the meaning of Bankruptcy Act § 68. The courts below found that the Bank could not interpose the argument of mutuality because ALC's account was operated for special purposes.

The Bank's argument that any controversy over ALC's account at the Bank did not involve ALC so that ALC's counterclaims should have been dismissed for lack of subject-matter jurisdiction, is specious. The Bank merely reiterates a previous claim, rejected by the courts below, that only the creditor parties to the 1970 and 1971 Agreements are entitled to share in the funds in ALC's account. If there was no mutuality of debts under Bankruptcy Act § 68a, the Bank must return the funds improperly set off to the ALC account. By virtue of Bankruptcy Act § 70a, under which the trustee succeeded to the title to ALC's property, the funds set-off by the Bank would be returnable to the trustee.

The Bank's contention that there was no intention that ALC benefit from the provisions of the 1970 and 1971 Agreements is contrary to the wording of the Agreements, the intention of which was to effect benefits for all signatory parties. Thus, the recital to the 1970 Agreement provided

that the "signatory parties," which included ALC, wished to reschedule the terms of payment of sums due from ALC to its creditors:

"[I]n a manner mutually agreed upon to be in the best interests of all parties concerned." (Emphasis added.)

It was intended that ALC would benefit from the arrangements by extending restructuring and reducing its debts with a view to rehabilitation. Accordingly, it is proper that the order of March 1, 1977 provide that the funds set-off by the Bank be returned to the bankrupt estate.

Moreover, under Bankruptcy Act § 70e, any transfer made or suffered that is voidable for any reason by any creditor of the debtor having a claim provable in the bankruptcy proceeding is null and void as against the trustee, and all property of the debtor affected by such transfer remains part of the estate and passes to the trustee for the benefit of the estate. In Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 140 (7th Cir. 1969), the Seventh Circuit Court of Appeals held that a trustee could maintain an action pursuant to Bankruptcy Act § 70e because it:

"will accord with the purposes of the Bankruptcy Act and avoid multiple individual or complex class actions that might result in inequitable distributions of assets of the bankrupt estate."

The courts below held that the funds in ALC's account were for the benefit of all creditors to the 1970 and 1971 Agreements. Those creditors were to share rateably, in such funds. The set-offs by the Bank of the funds in ALC's account were improper. Bankruptcy Act § 70e allows the trustee to succeed to the priority of any creditor over claims of another. The order of March 1, 1977 properly required the turning over of the "set off" funds to the trustee.

- (b) The bankruptcy court did not alter the terms of the "contract" between ALC and the Bank

The Bank's final point is that in making its decision the bankruptcy court purported to rewrite the provisions of the demand note, executed by ALC as security for the loan of \$100,000 drawn against the line of credit set up under the 1970 Agreement, and the assignment of the CD by ALC as security for the letter of credit issued by the Bank to cover ALC's prospective liability to the State of New Jersey in respect of sales taxes.

This claim made by the Bank merely mirrors the same claim made in Point III of its brief. The Bankruptcy Judge found that, in light of the evidence and testimony introduced at trial, the Bank could not successfully interpose a right of set-off against funds deposited into ALC's account at the Bank. Such deposits were made pursuant to the 1970

and 1971 Agreements. The assignment of the CD to cover the prospective liability to New Jersey sales taxes occurred long thereafter. As Judge Goettel concluded:

"[T]o the extent the certificate was not used to satisfy the tax claim, the deposits it represents are subject to the same equitable trust which invalidated the set-offs, and, therefore, any assignment was void ab initio."

Furthermore, the assignment of the CD was a security device which did not assign the underlying equity. The money which the Bank purported to set-off, which was the balance of the CD remaining after the payment of ALC's liability to the State of New Jersey, constituted the equity of the CD remaining after the payment of the taxes. Therefore, because the equity therein had not been assigned, the Bank had no priority right in such funds. Those funds should also have been returned to ALC's account. The successor in interest to that account is ALC's trustee.

CONCLUSION

The decision below should be affirmed in all respects.

Respectfully submitted,

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SERVICE OF TWO COPIES OF THE WITHIN BRIEF
ACKNOWLEDGED THIS 30TH DAY OF JANUARY, 1978

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